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Monthly Letter on Economic Conditions Government Finance

New York, August, 1947

General Business Conditions

THE business news of the past month has been featured by a change from widespread expectations of recession in the second half of the year, to concern whether inflationary forces once again are assuming control. This change in sentiment has sprung from a combination of developments – the coal mine wage settlement with its threat of touching off a new wage-price spiral, the rise in agricultural prices, the discussion of large loans or grants to Europe, and the good record of business activity in the month when some decline had been looked for. The alteration in psychology has been reflected in the advance in stock market prices, which in turn has generated more bullish views about business prospects.

The coal miners' walk-out fortunately was short-lived. Any major interruption to industrial activity would have been deplorable, plunging the country into new economic and social disorder, feeding the fires of inflation, and weakening our position abroad at a time when the world desperately needs our moral and material leadership. An uninterrupted flow of goods was achieved, however, at the expense of a substantially higher cost for mining coal. This was reflected in higher coal prices, and—along with advances in steel scrap and other steel-making costs—was followed by increases in prices of steel mill products. At the same time, the coal miners' wage demands are being followed by new wage demands among other groups of workers—textile, glass, rubber, and copper workers, for example. What all this is heading up to ultimately has still to be determined.

Sustained Employment, Production, and Trade

Most solid basis for reviving confidence in business lies in the record employment, and continued evidence of sustained consumption and high buying power on the part of the American people. The dollar volume of retail trade has continued to run above a year ago, enabling retailers to work down inventories and commitments which last Fall and early this year were threatening to become burdensome. As a result, retailers have found themselves under the necessity of going back into the markets with buying orders to replenish stocks and prepare for Fall business.

All this has been reflected back into the wholesale markets and provided new stimulus for the non-durable goods industries, where some lagging was expected or already showing. In the textile industry which had been expected to lead a recession in non-durable goods, demand has expanded and prices strengthened. Cotton print cloth producers are well booked through the balance of the year, and some sales have been made into the second quarter of 1948. The situation in heavier cotton goods, which had been easy until recent weeks, likewise has improved. Firm demand also exists in rayon yarn and textile mar-

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kets; and wool textile and apparel industries are active on Fall business.

There are few signs of let-up in the durable goods industries. Steel and automobiles, striving to catch up with demand, are still backed with large orders, and the same can be said of electrical equipment and heavy machinery and engineering lines generally. Apparently business can continue to count on the support of large spending by business concerns for new plant and equipment; according to government calculations, the total of such expenditures contemplated for the third quarter is in excess of those planned for the two preceding quarters and approximates the peak reported for the fourth quarter of 1946. At this rate the dollar totals are running 85 per cent above 1941 and more than 60 per cent above 1929, the two prewar highs. Adjusting for the substantial price increases, expenditures projected for the third quarter were said to be still at a higher rate than in either of those years.

Home building, which has been retarded by high costs and labor and material shortages, has recently turned in somewhat better reports. Housing "starts" in June, according to the Bureau of Labor Statistics, totalled 75,000 permanent dwelling units. This was 2,500 more than in May, 10,000 more than in June last year; and, as the Bureau points out, the continued rise is significant since June frequently has marked the beginning of a seasonal decline in the number of new homes started. With government restrictions on non-residential construction ended June 30, daily average contract awards for such construction (mostly industrial and commercial) in the first half of July were reported by the F. W. Dodge Corporation as 27 per cent over the June daily average, but 6 per cent under July last year.

Pessimism Overdone

In short, it is now clear that, as matters have developed, bearishness has been overdone. People have underestimated the strength of supporting influences in the economy — among them the large deferred demands for goods, our huge exports financed to a great extent by American gifts and loans, and the degree to which business has "cleaned house" following the warning of the stock market break last Fall. It was, indeed, very largely because of such warnings that brakes were applied to inventory buying in time, and hence that the recession feared did not materialize.

This, however, does not warrant swinging to the other extreme of taking it for granted that we are in a new inflationary uptrend and that business can afford to abandon prudent policies which have proved so generally salutary over the past nine months. Inflation thrives on three conditions: (1) continuous additions to the money supply; (2) general shortage of goods; and (3) bullish psychology. At present the money supply, though huge, is no longer increasing. Shortages of goods still exist, but in most lines they become steadily less acute, and many pipelines are becoming well filled. As for psychology, it is difficult to say what that will be from one week to the next. An additional factor of importance is the improbability of exports holding up to the present extraordinary levels; already our exports are being curtailed in some markets, as indicated by a subsequent article in this Letter.

Certainly this is no time to throw caution to the winds, with the risk of inviting another inflationary spurt, from which the reaction could be a good deal more serious.

The Half Year's Earnings

Industrial and trade corporation reports for the first half year continue in the aggregate to reflect the profitable operation that goes with greatly expanded volume. With employment lifted to the 60 million job level for the first time in peacetime history, and with supporting evidence of prosperity on every hand, total industrial earnings were apparently above the high level reached in the last half of 1946. They were approximately double those of the first half of 1946, when large segments of the durable goods industries were severely curtailed by strikes, materials shortages, and reconversion difficulties.

Although net income of the manufacturing companies as a group was above that of the second half of 1946, about a third of the reporting companies showed lower net earnings, due to labor, material, and other costs increasing faster than sales. Declines were shown by such industry groups as food products, brewing and distilling, textiles and apparel, drugs and cosmetics, as well as by numerous companies in other groups. Earnings of aircraft manufacturers were affected adversely by the heavy slump in business following the war, while earnings of steel companies, though up compared with the first and second halves of 1946, nevertheless showed a sharp downturn between the first and second quarters of this year.

Narrowing profit margins in the merchandising lines is indicated by the reports of 24 companies engaged in retail and wholesale trade, whose combined net income averaged 2.6 cents per dollar of sales in the first half of 1947, against 3.3 cents in the second half of 1946, and 3.9 cents in

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST HALF YEAR

Net Income is Shown as Reported – After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends. Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

		Net Income			Net Worth		Annual Rate of Return %		
No. of Cos.	Industrial groups	1st Half 1946	2nd Half 1946	1st Half 1947	January 1 1946	January 1 1947	1st Half 1946	2nd Half 1946	1st Half 1947
25	Food products	$ 75,731	$ 115,164	$ 113,185	$ 993,915	$ 1,088,836	15.2	23.2	20.8
7	Brewing and distilling	51,440	65,834	42,338	258,254	343,092	39.8	51.0	24.7
25	Textiles and apparel	16,377	27,149	22,111	198,414	232,411	16.5	27.4	19.0
25	Pulp and paper products	22,837	31,278	53,788	375,523	464,801	12.2	16.7	23.1
30	Chemicals and paints	118,112	132,412	155,065	1,604,977	1,722,349	14.7	16.5	18.0
8	Drugs and cosmetics	10,511	9,054	5,526	72,274	99,774	29.1	25.1	11.1
19	Petroleum products	213,800	263,363	349,248	4,229,522	4,532,766	10.1	12.5	15.4
20	Cement, glass and stone	25,220	40,719	50,259	485,762	554,890	10.4	16.8	18.1
32	Iron and steel	77,599	168,696	198,918	3,363,947	3,447,891	4.6	10.0	11.5
18	Electrical equipment	940	77,308	83.194	870,602	932,667	0.2	17.8	17.8
34	Machinery	13,661	26,713	37,012	401,497	443,698	6.8	13.3	16.7
12	Autos and trucks	D-18,965	120,291	172,298	1,569.401	1,677,362	—	15.3	20.5
16	Auto equipment	155	15,167	26,639	179,032	224,078	0.2	16.9	23.8
76	Other metal products	62,027	113,544	115,086	1,204,292	1,353,073	10.3	18.9	17.0
30	Miscellaneous mfg.	32,369	44,829	52,746	482,643	520,819	13.4	18.6	20.3
377	Total manufacturing	701,814	1,251,521	1,477,413	16,290,055	17,638,507	8.6	15.4	16.8
31	Mining and quarrying	29.491*	48,011*	54,612*	694,750	737,686	8.5	13.3	14.8
24	Trade (whol. and retail)	36,496	39,309	30,790	336,376	383,883	21.7	23.4	16.0
19	Service and amusement	27,229	31,455	27,959	410,122	442,508	13.3	15.3	12.6
451	Total	$795,030	$1,370,296	$1,590,774	$17,731,303	$19,202,584	9.0	15.5	16.6

*Before depletion charges in some cases. D- Deficit.

the first half. Earnings of some companies in these lines have been cut sharply by consumer resistance and slowing down of sales, and by the rise in selling expense ratios and in the markdowns necessary to move goods.

In the aggregate, our tabulation of reports of 451 leading companies representing for the most part the larger manufacturing organizations but including also some engaged in mining, trade, and service, shows combined net profits after taxes of approximately $1,591 million in the first half year 1947, an increase of 16 per cent over the $1,370 million in the last half of 1946. They were double the $795 million in the low first half of 1946 which included heavy deficits in many cases. On the capital and surplus totalling $19.2 billion at the beginning of this year, the first half 1947 net income was at an annual rate of 16.6 per cent, compared with a rate of 15.5 per cent in the preceding half year and 9.0 per cent in the first half of 1946. The above table gives the totals by major industry groups.

The record of employment, production, and profits shows what the economic system can accomplish when working at high speed and without substantial interruptions. In the manufacturing industries the tremendous expansion in volume of business is indicated by the sales figures reported by 221 companies totalling $12,188 million, which were 17 per cent above the second half of 1946 and 67 per cent above the first half. As analysis of the figures has shown, high volume rather than any extraordinary widening of profit margins has been mainly responsible for the generally favorable corporate results over the past twelve months.

Quarterly Steel Earnings Lower

Separate quarterly figures for 1947 available for 310 manufacturing companies showed second quarter net income 1½ per cent below the first. A group of 29 steel producers had a decline in net income of 20 per cent, due principally to the higher wage costs under the contracts which become effective April 1, but also to higher prices paid for scrap, fuel, and other supplies and services. The wide fluctuations in quarterly earnings of this group are shown in the following table giving net income after taxes.

Quarterly Earnings of 29 Steel Companies

1946	First quarter	$18,043,000
	Second "	59,594,000
	Third "	81,512,000
	Fourth "	86,390,000
1947	First "	109,442,000
	Second "	87,086,000

The table reveals the low earnings (after deduction of a number of deficits) in the early part of 1946, the rapid recovery during the latter part of the year and first quarter of 1947, followed by the recession in the second quarter. The latter explains the recent action by the steel companies in advancing prices on finished steel products last month.

Adjustments to Postwar Conditions

The apparent slackening in the rate of corporate income expansion, and even reversal of the rise in important instances, reflects a natural adjustment to postwar conditions. For a time business was going through a phase during which net income was swelled with little effort by sellers' markets, by advancing prices after ending of OPA controls, demand for filling distribution

"pipelines", and elimination of excess profits taxes. In addition, many companies had special accounting credits arising from tax refunds or contingency reserves.

Gradually, however, many of these factors making for easy gains are passing. With industrial reconversion largely completed, high level production has been making inroads upon deferred demand in one line after another. Sellers' markets are here and there giving way to more competition, costs are rising, and now and again inventory profits are being turned into inventory losses.

All this means that business skill and resources are being put increasingly to the test, with an inevitable upturn in commercial failures, which according to Dun & Bradstreet reached 283 in June of this year, against 74 in July 1946. Some of these failures were war-expanded companies unable to develop new products or peacetime markets, while others were postwar retail and service enterprises unable to meet the increasingly competitive conditions.

Unpegging Treasury Bill Rates

The decision by the Federal Reserve authorities last month to terminate their fixed buying and selling rate of ⅜ per cent for 90-day Treasury bills marks a further long-expected step in the process of adjusting monetary and credit policy to peacetime requirements.

Under the new program the Federal Reserve Banks will continue to buy and sell "old" bills at the former pegged rate, but "new" bills issued on and after July 10 will be permitted to find a new level of yields in the market. Though discontinuing the fixed bill rate, the Federal Reserve has made clear that it was not abandoning either the bill market or government securities in general to their own devices. "The Federal Reserve System," it was stated, "will continue to purchase and hold Treasury bills as well as other government securities in amounts deemed necessary to the maintenance of an orderly government security market and the discharge of the System's responsibility with regard to the credit situation of the country."

In the first weekly sale following inauguration of the new policy, the average yield at which new issues of Treasury bills were subscribed rose from the old posted rate of .375 per cent (⅜) to .59 per cent, and in the two succeeding weeks to .73 and .74 per cent.

War-Time Rate Pattern Broken

The action by the Reserve System in unfreezing the bill rate means the first open break away from the pattern of interest rates determined upon for financing the war. This was approximately the pattern prevailing in the latter part of 1942, and ranged in an ascending curve from ⅜ per cent on 90-day Treasury bills and ⅞ per cent on one-year Treasury certificates to 2½ per cent on the longest-term Treasury bonds.

In order to maintain this pattern of rates it was necessary for the Reserve Banks to buy huge quantities of government securities, and it was as part of this program of supporting the rate structure and of supplying the money market with funds adequate for war financing that the pegged bill rate was established. This device had the effect of both providing a firm anchor at the short-term end of the "interest rate curve", and of encouraging banks to a full use of their reserves in war financing by making their bill holdings practically the equivalent of cash. At the same time banks were encouraged to borrow from the Reserve Banks on their short-term Treasury paper by an especially low discount rate of ½ per cent on this type of borrowing.

The whole program, of course, involved a tremendous expansion of bank credit, with consequent enhancement of inflationary pressures throughout the economy. While it is a disputed point whether our wartime financing methods were as effective as they might have been in limiting the expansion of credit, there is no question but that, considering the vast sums to be raised, a large part of this expansion was unavoidable. So long as the war was on, central bank policy was necessarily subordinated to the needs of the Treasury.

Moves to Control Credit

Since the end of the war and discontinuance of heavy Treasury borrowing, however, we have faced an altogether different situation. The problem has no longer been to expand, but to check the growth of money and credit that has been so potent a factor in inflation. Accordingly, the monetary and fiscal authorities have been moving slowly in a series of steps to adjust their policies to the new conditions.

One of these steps was the rescinding in April 1946 of the Federal Reserve ½ per cent preferential discount rate against short-term governments, thereby making the regular 1 per cent rate effective for all borrowing, and diminishing the incentive for banks needing funds to borrow from the Reserve Banks instead of liquidating government securities.

Another and more important step was the Treasury policy of using excess cash built up in the commercial banks by the Victory Loan, for

the repayment of public debt. Since a substantial part of the debt redeemed consisted of short-term obligations held by the Reserve Banks, this had the effect of reducing bank cash and forcing banks to borrow or sell securities in order to maintain their reserve positions, with a consequent tendency to restrict further expansion of credit.

Mainly because of this pressure upon bank reserves, the monetary authorities were able during 1946 to postpone unpegging of short-term money rates without inviting serious monetary and credit enlargement. Moreover, even after exhaustion of Victory Loan balances, this pressure was continued through the first quarter of 1947, owing to a heavy current surplus of Treasury cash receipts over expenditures, some of which was used for additional debt retirement while the rest piled up in the Reserve Banks and took money out of the market.

More recently, however, these influences which heretofore have been chiefly responsible for putting a damper on credit expansion have substantially weakened. Slackening in the rate of debt retirement following depletion of Victory Loan cash has lessened pressure upon bank reserves from that quarter, while disbursement of the large Treasury balances accumulated in the Reserve Banks has restored funds to the market. At the same time, bank reserves have been reinforced by renewed imports of gold, amounting to over $1½ billion since the first of the year and reflecting payments by foreign countries for record American exports.

Factors Speeding Action

All this has raised again the question of postwar monetary policy and of the need for restoring to the monetary authorities a larger degree of freedom in dealing with postwar problems. At the same time these problems have been given added emphasis by reappearance of inflationary symptoms in the general economy, and by a fresh buoyancy in the Treasury bond market and consequent decline in long-term yields which have been scarcely restrained by recent heavy sales of long-term Treasury bonds out of government trust funds. The danger involved in any further depression of long-term interest rates, and the need for permitting some greater degree of flexibility of short-term rate controls, were stressed in the 1946 annual report of the Board of Governors of the Federal Reserve System, as follows:

> In view of the large public debt outstanding, it is desirable to maintain at the existing low levels the rate at which the Government can borrow on its long-term obligations. At the same time, it will be desirable to avoid further declines in rates which reflect the pressure of excessive bank credit expansion rather than a surplus of current savings over capital demands of business. Further decline in long-term rates would reduce the return on savings invested in marketable issues and lower the incomes of endowed and saving institutions which depend on earnings from investments. This would seriously impair the functions of these institutions and lead to a weakening of our social and economic structure.
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> If the tendency for banks to shift from short-term to longer-term securities should be resumed, it could be discouraged by discontinuance of the Federal Reserve policy of purchasing short-term government securities at present low rates. This would result in a rise in short-term interest rates and thus reduce the incentive for further monetization of the public debt. While it would continue to be necessary for the System to support government securities and maintain an orderly market, the relationship between rates for various types of market issues might be permitted to become more responsive to demand and a greater degree of flexibility would be restored to control of credit through the money market.

The unpegging of Treasury bill rates is thus a step towards the greater credit flexibility recommended by the Reserve authorities.

The Next Step

It is, however, only a small step, by reason of the greatly reduced volume of Treasury bills now held outside the Federal Reserve Banks. As pointed out in the official announcement of the new bill policy, increased amounts of bills have been sold to the Reserve Banks by the market until currently only about $1.5 billion of the nearly $16 billion total of bills outstanding are held outside the central banks. Thus, "certificates of indebtedness, which bear a higher rate than Treasury bills, have largely replaced bills in the market, not only as a medium for investment of short-term funds, but also as a means by which banks adjust their reserve positions."

The next logical step, therefore, in the unfolding of the new credit policy would be unpegging the ⅞ per cent certificates and allowing the rate to rise to levels less dependent upon the Reserve Banks for support. The August 1 offering of certificates with a ⅞ per cent coupon for eleven months instead of the customary twelve would facilitate such a move, since by September this will be a 10 months issue and the Treasury could then offer a higher coupon issue without depressing this issue.

Reducing Government Expenditures

The past six months have provided a practical demonstration of the exceeding difficulties of getting government expenditures back under control, once effective restraint has been lost. With Chairman Taber and Vice-Chairman Wig-

glesworth on the House side and Chairman Bridges of the Senate spear-heading the drive, the members of the Congressional Appropriations Committees during these months have been working through the massive, fourteen-hundred page budget for the fiscal year ending June 30, 1948, and listening to the testimony of countless government officials and other witnesses to determine where and how much the \$37½ billion the President proposed to spend could be cut down. The passage of the last major appropriations bills late in July makes it now possible to appraise how they have come out. The following table shows, by the major branches of Government, how the appropriations approved by Congress compare with the appropriations requested by the President.

Appropriations for the Fiscal Year Ending June 30, 1948
(In Millions of Dollars)

	Proposed by President	Accepted by Congress	Percentage reduction
Military Establishment	5,716.8	5,482.5	4.1
War Department—Civil functions	619.7	502.1	19.0
Navy Department	3,513.0	3,268.8	6.9
Veterans Administration and other independent offices	8,500.5	8,188.8	3.7
Treasury Department			
Tax refunds	2,031.0	1,231.0	39.4
Other	523.0	453.8	13.2
Postoffice Department	1,545.1	1,531.7	0.9
Labor Dept. and Related Agencies			
Labor Department	103.6	75.9	26.7
Federal Security Agency	976.4	901.7	7.7
Other related agencies	699.7	696.6	0.4
Agriculture Department	805.1	613.0	23.9
Interior Department	296.1	194.6	34.3
Commerce Department	287.0	191.9	33.1
State Department	279.7	232.7	16.8
Justice Department	111.5	107.5	3.6
Judiciary	20.6	19.0	7.8
Government corporations	106.6	80.6	24.4
Legislative branch	76.2	55.3	27.4
District of Columbia	95.8	95.5	0.3
Permanent and indefinite appropriations			
Interest on the public debt	5,000.0	5,000.0	—
Other	362.3	362.3	—
Supplementals	2,191.1	1,810.0	17.4
Total	33,860.8	31,095.3	8.2

Based on a tabulation published in the Congressional Record for July 26, 1947, page D616. Permanent appropriation for sinking fund to retire public debt is excluded.

In his January budget proposals the President requested Congress to appropriate \$31.3 billion for the 1948 fiscal year. In addition, it was indicated that substantial use would be made of appropriations and authorizations carried over from previous years. Such carryovers accounted for the difference between the \$31.3 billion request for new appropriations and the \$37½ billion proposed to be spent.

Since January, the President has added many hundreds of millions for items which were not foreseen in the budget – for example, \$400 million to aid Greece and Turkey, and \$250 million as the first instalment on a new \$4 billion flood control plan for the Mississippi River basin. While the appropriations legislation was under consideration, moreover, some of the government departments revised their requirements, most often in the upwards direction. And Congress itself, with the President's approval, made smaller additions, such as raising allowances under the veterans' educational program. Thus a determined effort was required simply to keep the budget from swelling well beyond the bounds indicated in the proposals submitted by the President last January.

Appropriations made for 1948 totalled \$31.1 billion, a reduction of \$2.8 billion from the \$33.9 billion the President asked for either in the original budget or in supplemental requests. Aside from the cut in 1948 appropriations, Congress disallowed some of the requests for extra money for fiscal 1947, rescinded \$3 billion in appropriations carried over from previous years and not yet used, and recovered considerable funds which might otherwise have been spent by government agencies.

The Committees' Approach

In going over the budgets for the military services, the Appropriations Committees' objective was to cut out waste and extravagance without sacrifice of efficiency. With the Army it was felt that the percentage of officers – 13½ per cent of total personnel compared with the previously planned 10 per cent – was unjustifiably high. Bonuses for flying personnel were discovered to be loosely administered as well as disproportionate to the present risks of flying. The Army was urged to save money and obtain a better control by centralizing its procurement, by sharing duplicate facilities with the Navy, and by improving its accounting and cost records. With the Navy, the Committees discovered that a shift of training activities from the shore to the fleet might cut personnel requirements by more than 25,000 men.

The Committees looked with an especially critical eye on departments and bureaus with swollen administrative overhead, on overlapping of activities between departments or between bureaus within departments, on "public relations" or "publicity work", and on expensive research activities of an "academic", "visionary" or "speculative" character. In harmony with the President's efforts last Fall and Winter, as well as in recognition of the continuing housing shortage and scarcities of labor and material, the Committees cut back public works programs. In the Department of Agriculture soil conservation payments were extended for another year, through 1948, though with maximum payments

to any one farmer reduced from $10,000 to $500. With the Veterans' program, the attention of the Committees was directed to large possible areas of savings — in the hospital program, in overhead expenses, and in the handling of the National Service Life Insurance Fund. The foreign aid program was enacted with relatively minor cuts such as the elimination of Poland from the list of countries to be granted relief assistance.

How Much Cut in Expenditures?

How much these cuts in *appropriations* will mean in terms of *expenditures* cannot be foreseen with assurance. Many of the appropriations cuts should result in corresponding reductions in expenditures from the originally projected rates. In other cases, wastes have been discovered which the bureaus have agreed to correct. In still other cases, areas have been disclosed where savings are possible though they may not be immediately realized. The final expenditure total, of course, will not be known until the fiscal year ends on June 30, 1948, though the Bureau of the Budget will work up revised estimates based on the Congressional action and data submitted by the departments.

The negative side of the record shows that many of the cuts approved by the House of Representatives were not sustained by the Senate and had to be whittled down to reach a compromise. Likewise the addition of new items not contemplated in January will neutralize many of the savings. In a few instances savings have been disputed, most notably the reduction of $800 million in appropriations for tax refunds. Here more money will have to be appropriated should the figure allowed prove to be too low.

The experience emphasizes the difficulties involved — the complication of government organization and accounting methods, which often seem calculated to prevent rather than promote understanding; the stern battle waged by bureau chiefs against cuts in their funds; and distorted reports that got around of the effects of the cuts and resultant letters of protest to Congressmen from back home.

Cut for Bureau of Internal Revenue

Perhaps the most damaging criticism of the Appropriations Committees' work came when the President, in approving the Treasury-Post-office appropriation bill on July 1, issued a statement to the effect that "the reduction of $20,000,000 in the appropriation for the Bureau of Internal Revenue will mean a reduction in personnel of 4,000 to 5,000 employees and will result in a direct loss of revenue of not less than $400,000,000." This sounds like blind budget slashing, and in the face of such a statement many people would be inclined to agree with some members of Congress that the Bureau should have been given more money rather than less.

Following the President's criticism the House Appropriations Committee assigned its investigative staff to the task of determining how the Bureau had made its cuts and the opportunities for introducing savings without loss of revenue. A preliminary report submitted by the staff late in July questions the "sound administrative practice" of the action taken by the Bureau. According to the report, the Bureau applied all of the cut to the work force out in the field, with little or no allowance for a drop in related operating expenses or in Washington personnel.

The Bureau, the report went on to say, imposed the cut by an arbitrary rule which took no account of amounts of taxes collected by the various district offices but only of the number of returns (irrespective of kind or complexity) handled. In consequence, one important office had its number of field deputy collectors cut in half, while some other offices merely cut down the number of vacant positions on their staffs, or were able to take on people released elsewhere within the Bureau. The number of suggestions made in the report for eliminating waste motion, together with the fact that a number of the persons dropped had been given unsatisfactory efficiency ratings, seems to indicate that there is room to tighten up efficiency without loss of revenue. A cut in appropriations, while it can be overly harsh and arbitrary, is often the only way to create pressure looking to increased efficiency.

Obstacles to Retrenchment

It would be contrary to human nature if many government administrators did not resist, after the long "fat" years, making up salary increases by increased efficiency; giving up plans for additional new projects; and abandoning present activities which they may sincerely feel to be "indispensable" but which, on close analysis, do not warrant their costs. Some relevant observations were published in "The Federal Employee", official organ of the National Federation of Federal Employees, last March while the Appropriations Committee hearings were under way:

> With a Congress which for years has been very liberal with appropriations, many of which were not earmarked and therefore often available for purposes which Congress never intended, there has been permitted the expansion of some agencies considerably out of line with the purpose for which they were created . . .
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> . . . some (administrators) even have gone so far as to state that their agencies cannot be curtailed in the slightest degree which, even if true, is an unfortunate ap-

proach . . . Other administrators, who have acquired certain expensive habits with regard to Federal spending which they do not wish to alter, have gone so far as to intimate that they can outsmart the Congressional appropriations committees to secure all the funds they seek.

Heads of some agencies that were clearly overstaffed have neglected to clear the deadwood out of their own official corners, either through political expediency, laxity administrative inefficiency, or other equally indefensible reasons . . .

It almost would seem at times that some administrators instead of trying to preserve in the most efficient manner possible the official organizations entrusted to them, were trying to wreck them by giving substance to the most violent criticisms leveled at Federal administration and Federal employment.

Generating Kickbacks to Congress

Some further insight into how "practical politics" works to defeat economy was given in a speech by Congressman Norris Cotton of New Hampshire before the New Hampshire Federation of Taxpayers' Associations last Spring. "The departments of Government," he said,

do not content themselves with the mere presentation of their cause but they sometimes resort to desperate and questionable means to prevent budget reduction. When the general budget bill was before Congress the War Department notified many Congressmen by telephone that the air fields in his District would be discontinued if their budget was reduced. When the Customs Service appropriation was reduced 10% the head of the Bureau took no steps to reduce in number the 33,000 employees in Washington but notified the 25,000 operatives in the field that their jobs were in danger and told them to build a fire under their Congressman.

. . . It is obviously impossible and impractical for Congress to attempt to say what employee should be dispensed with or what services should be curtailed. It can only reduce after careful consideration by a reasonable percentage the appropriation of a department, division, or bureau, and rely upon the head of the bureau to apply the necessary economy. In almost every instance bureau heads apply the reduction not where it hurts the least but where it hurts the most, so that not only every employee but every benefactor of the department will apply pressure to Congress to restore the reduction.

Expenditures and Taxes

It is clear that the task of getting government expenditures, taxes, and debt down, if the job is to be done, will require a persistent effort backed up by a wide and unwavering public support. The strongest force behind that public support, quite evidently, is the promise that economy in Government will relieve the citizen of some of his taxes. This was evidenced by the enthusiasm for budget-cutting to make possible a first instalment of tax relief this year. It was evidenced again in the weakening of the economy effort after two tax reduction bills, both passed by large majorities, were killed by Presidential veto.

The argument is entirely plausible that revenues should be held up while expenditures are curtailed so as to accelerate retirement of the vast debt. Nevertheless, if money over and above a reasonable allowance for debt retirement is available, reasons are almost certain to be found for urging the diversion of such funds to new spending projects. The recommendation to start a $4 billion new flood control plan, which followed the tax vetoes, is an example of this tendency. The citizen should ponder well whether big additions to an already record-breaking public works program are of greater benefit to him and to the country than a corresponding measure of tax relief would be.

In the speech to which reference already has been made, Congressman Cotton summarizes an experience of disillusionment which many citizens and their representatives in Washington doubtless have shared:

When I went down to Washington I had a very beautiful theory as to the manner in which we should handle budget and tax reduction. I believed that we should reduce government expenditures first, balance the budget, make a start toward retiring the national debt, and then and not until then we should consider tax reduction. I believed that while money was cheap and employment plentiful we should continue for a time to collect taxes on the present schedule, in order that we might have a backlog for the future. I still maintain that this is a logical and sound program. The only trouble with it is that it won't work.

The Government will spend all the money it can get, and the only way to reduce the cost of government is to reduce the revenue of government.

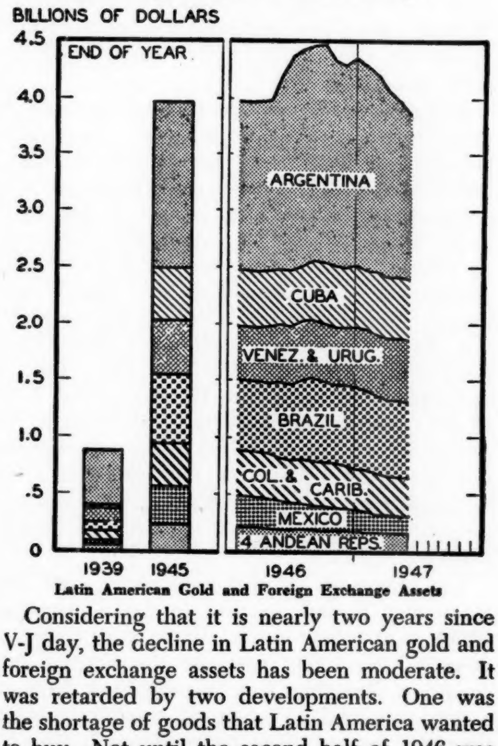
This sounds like a rather extreme statement Yet its essential kernel of realism is demonstrated by the course of events. We stand the best chance of getting orderly financial housekeeping in Government when the citizen sees that the money the Government spends is coming out of his own pocket.

Latin America's Dollars

Western Europe is our largest market, but Latin America is our biggest cash-paying customer. The Latin American countries accumulated gold and foreign exchange assets during the war and are now using them, together with the proceeds of current exports, to pay for American goods on a stupendous scale. But with our sales to Latin America during the first five months of this year exceeding $330 million a month and our purchases averaging around $185 million a month, these assets are being drawn down. In a few countries they have already been depleted to such an extent that the financing of import surpluses is becoming increasingly impracticable; the supply of dollars is becoming limited to what is derived from current exports.

The regularly reported gold and foreign exchange assets of Latin American countries continued to expand for more than a year after the end of the war and reached a peak of about $4.5 billion in September 1946. Including additional central bank reserves reported either belatedly or irregularly, foreign exchange claims of commercial banks, and privately-owned dollar balances in this country, the overall total was probably near $5 billion.

It appears that in recent months the balances have been used up at a rate exceeding $100 million a month. As will be seen from the chart below, the regularly reported gold and foreign exchange assets have declined since last September by about $700 million, to about $3.8 billion by the middle of the year. At that figure they were still nearly five times as high as before the war. It may be emphasized at this point, however, that at least one-fourth of Latin American gold and foreign exchange assets – or almost $1 billion – represented the dollar equivalent of blocked sterling or other inconvertible currencies not usable for purchases in this country.



Latin American Gold and Foreign Exchange Assets

Considering that it is nearly two years since V-J day, the decline in Latin American gold and foreign exchange assets has been moderate. It was retarded by two developments. One was the shortage of goods that Latin America wanted to buy. Not until the second half of 1946 was the United States able to catch up with demand. Latin America's imports from Europe are still but a fraction of the prewar volume. At the same time, Latin American exports have held up extremely well. The demand from the United States has been strong because of high business activity here, and from Europe it has been strong because of dire needs. Many Latin American export products up to a few months ago encountered little competition in world markets, because of the slow recovery of Southeastern Asia. Some of the Republics have enjoyed an even greater boom than during the war.

Wide Differences Between Countries

However, the chart also shows that Latin American gold and foreign exchange reserves are unevenly distributed, and that the changes in reserves have differed markedly. Five countries, Argentina, Cuba, Venezuela, Uruguay, and Brazil hold among them more than four-fifths of the regularly reported Latin American gold and foreign exchange reserves. Uruguay, a country with only 2 million people, has reserves almost as large as the four Andean Republics and Colombia combined.

Gold and Foreign Exchange Assets of 16 Latin American Central Banks and Governments
(Expressed in Millions of Dollars)

	Gold and Foreign Exchange Reserves			Ex.-Imp. Bank Undisb. Loans (c)	Trade with U.S.	
	Peak (a)	Latest (b)	Change		Imports from U.S. (d)	Import Bal. (d)
Argentina	$1,835	$1,355	—480	—	614	— 436
Bolivia	38	29(f)	— 9	10	31	— 9
Brazil	754	636	—118	50	730	— 280
Chile	110	67	— 43	48	131	— 27
Colombia	187	141	— 46	15	243	— 27
Ecuador	36	22	— 14	10	51	— 32
Paraguay	13	12(g)	— 1	—	9	— 6
Peru	38	28(g)	— 10	—	106	— 66
Uruguay	292	282(f)	— 10	8	102	— 67
Venezuela	249	246	— 3	—	431	— 258
Costa Rica	16	5(g)	— 11	—	35	— 14
Cuba	608	608	—	7	488	+ 17
Guatemala	52	52	—	—	43	+ 11
Mexico	380	191(e)	—189	80	667	— 404
Panama	89	75(h)	— 14	—	132	— 125
Salvador	35	34	— 1	—	27	+ 23
Total		3,783		248(i)	3,840	—1,700

(a) Peaks for individual countries in most cases established between Dec. 1945 and Oct. 1946. (b) May-June 1947. (c) June 15, 1947. (d) Based on U. S. trade figures; 1947 annual rate computed on the basis of first five months. (e) Partly estimated. (f) March 1947. (g) April 1947. (h) February 1947. (i) Including $25 millions for miscellaneous projects in Latin America.

NOTE: The figures used for Cuba include the Cuban Treasury's gold and U. S. dollar holdings together with the dollar reserve held against silver certificates; also U. S. dollar notes and coins held by commercial banks and the public; the Panamanian figures represent balances held in U. S. banks as reported by the U. S. Treasury.

Recent changes have further accentuated the uneven distribution. Cuban and Venezuelan reserves hold at the peak, largely because of heavy exports of sugar and petroleum at high prices. But as will be seen from the table, the gold and foreign exchange assets of most countries have declined. By far the largest drop, nearly half a billion dollars in the nine months ending June 15, has taken place in Argentina – a country which as late as last April had an export surplus in her aggregate trade. Argentina has drawn on her

reserves to redeem foreign-held public debt and to purchase foreign-owned public utility properties. Although reported Argentine reserves at $1,355 million are still large, only about two-thirds consist of gold and freely convertible currencies. The balance represents largely blocked pound sterling expected to be used in the near future to pay for British railway properties.

Not all Argentine exports have created foreign exchange. A part has represented overdraft accommodations and long-term loans, aggregating some 2.4 billion pesos or $580 million, extended to various European and Latin American countries. Argentina's deficit in her trade with the United States is currently at a rate above $400 million a year.

The reserves of Mexico, which this year is buying at an annual rate of about $650 million, are down to about $190 million from the peak of about $380 million. Colombia has lost about one-fourth of her reserves. The reserves of Chile, Peru, Bolivia, and Ecuador, never too large, have been under pressure for some time.

Shortage of Dollars

Another fact not revealed in overall figures is that the decline has been concentrated in gold and dollar holdings. The actual gold reserves declined from about $2.8 billion in September to $2.1 billion in May. On the other hand, the holdings of inconvertible currencies in some cases have increased. For example, of $350 million representing the foreign exchange reserves of the Banco do Brasil as of the end of February 1947, only $75 million were in the freely convertible currencies. It is safe to presume that since then a further decline in the latter figure has taken place.

The heavier drain on gold and dollars reflects, of course, the fact that Latin American countries have been buying so much more than they sell in the United States. At the same time they still have considerable export surpluses with the rest of the world. Last year the 20 Republics had an import surplus in excess of $200 million with the United States. In the same period, however, they had an export surplus of at least $1 billion with the rest of the world and, although not all of this was freely convertible, the dollar problem was not pressing. But during the first five months of this year Latin America's import surplus with the United States was at the annual rate of $1.7 billion. This figure, which does not include dollars required for dividend and interest payments or for freight charges, was far greater than prospective export surpluses with other countries.

Outlook for U. S. Exports

Except for a few European products offering strong competition, our position as the leading exporter to Latin America so far remains unchallenged. Our leading competitor, Great Britain, exported during the first quarter of 1947 about as much goods to Latin America as we exported in one week. About two-thirds of the total Latin American imports are being currently supplied by this country, as compared with about one-third before the war. In view of the situation in Europe, we are likely to continue to be the major supplier, and there is still a huge backlog of unsatisfied demand.

It seems impossible, however, to maintain our exports to Latin America at the present abnormal rate of nearly $4 billion annually. This is about eight times the prewar rate and 2½ times the value of total Latin American imports from all countries in the 1936-38 period. Cuba, Venezuela, Panama, and possibly Argentina, Uruguay, and Colombia could continue buying from this country at recent rates for an extended period. But other countries can hardly do so — even if the proceeds of exports elsewhere should be fully convertible into dollars — unless further credits are obtained from us or from the World Bank or the Monetary Fund.

To apply brakes on imports, either because of actual shortage of dollars or to prevent remaining reserves from being squandered on high-priced non-essentials, Latin American countries are resorting increasingly to import licensing, outright import prohibitions, and other measures. In Mexico, a drastic law temporarily prohibiting all imports of non-essentials was passed last month. Tariffs were raised on some commodities. Even Argentina is beginning to curtail imports of non-essential goods. In Peru, Bolivia and Chile, the authorities for some time have tried to gear the issuance of import permits to the foreign exchange created by current exports. Because of the difficulty in estimating future exports, however, there has not always been enough foreign exchange available to cover all import permits.

The shrinkage in dollar balances, and the slackening in our exports to Latin America which must follow in due course, have been inevitable. Now that we face the change, we should realize that it is a swingback from a highly abnormal to a normal condition rather than the reverse. The huge accumulations of foreign exchange during the war represented a demand for goods which could not then be satisfied. When the goods became available the demand came into the markets. Our huge exports

thus have represented deferred buying and hence a deferred balancing of our wartime trade accounts with the Latin American countries. As this is completed our exports must revert to whatever volume our customers can pay for out of the proceeds of shipments to us or of investments and loans. Rightly understood, the change need not be deplored. In this country the Latin American buying has been a factor in our inflation.

Transition Problems in Latin America

The passing of the peak in gold and foreign exchange accumulations may be interpreted, broadly speaking, as the beginning of the real war-to-peace transition period in the Latin American countries. While the situation varies from country to country, the common problem is one of finding a new and sound basis for prosperity after a period of inflated prices, inflated exports and, recently, inflated imports.

Inflation based on huge demands for Latin American products made tremendous headway during the war and has continued through the postwar period. Bank deposits and note issues have expanded, parallel with the accumulation of gold and foreign exchange reserves. It has proved impossible to hold down wages largely because their real purchasing power has been extremely low. Budgetary deficits have also contributed to the pyramiding of purchasing power. As a result prices today in most Latin American countries are higher than in the United States and in some substantially so.

Business activity has continued generally very high, but in Latin America as elsewhere the arrival of the transition period has created many uncertainties. As foreign exchange reserves are spent and more goods made available to buyers, counter-inflationary influences inevitably begin to operate. While on the whole deflation is not much in evidence, the beginnings of readjustment are nevertheless apparent. A very prevalent condition is the piling up of goods at the ports. For this there are several reasons. One is the inadequacy of docking and distributing facilities to handle the abnormal volume of imports. Another is the fact that in some places goods have been received for which import permits have been issued, but which cannot be paid for and distributed because the authorities were not providing the dollars.

In a good many countries, local manufacturing enterprises which received an extraordinary stimulus during the war are facing for the first time in five or six years competition from imported goods. Particularly in textiles, drugs, and electrical appliances, prices have eased. Sensing the change from sellers' to buyers' markets, consumers have been reducing their purchases. Because of rising costs, the local manufacturer is in a dilemma. Recent reports also tell of consumer goods accumulating in importers' hands; collections in many lines are definitely slower. On the other hand, prices of such goods as automobiles and refrigerators are reported to be still advancing.

Recent softening of prices of a number of export commodities such as coffee, hides, and vegetable oils and oil seeds has apparently brought about greater caution. It has brought home the realization that times may not always be as prosperous and that the purchasing power of exports based on high prices may shrink rapidly in the future. Actually the volume of exports of most Latin American countries is below the wartime peaks.

Prosperity in Latin America is dependent upon foreign trade and in last analysis Latin American costs and internal prices must be in line with those of the countries with which she trades. The degree of internal adjustment necessary will be affected greatly by the trend of world prices, and much will depend upon the course of events in the United States. If our business and incomes hold up we shall doubtless continue to buy a large volume of Latin American products at good prices. On the other hand, a business decline here would surely be felt in Latin America through a reduction in our imports and declining prices.

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